BAILEY D. GOTHARD

IBLA 97-5 Decided April 30, 1998

Appeal from a decision of the Minerals Management Service ordering the payment of additional royalties. MS-92-0378-O&G.

Affirmed.

1. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Generally

Under the "marketable condition" rule, royalty is due on the gross proceeds accruing to the lessee including payments for the cost of measuring, gathering, and compressing gas where such services are necessary to place the gas in marketable condition. Where these expenses are necessary to market the gas, deductions from the value of the gas for such expenses are not allowed whether incurred by the lessee or a third party, before or after the initial sale of the gas.

2. Oil and Gas Leases: Royalties: Generally

A lessee has an affirmative duty to obtain the best possible price for the benefit of the royalty owner, consistent with reasonable business judgment. Therefore, when the contract under which the natural gas is being sold provides for payment at the highest obtainable ceiling price under the NGPA, 15 U.S.C. §§ 3301-3432 (1982), the lessee has an affirmative duty to seek classification under the NGPA section affording the best possible price. If the lessee fails to exercise due diligence in obtaining a classification affording a higher sales price, the royalty may properly be calculated as if the higher sales price had been obtained.

APPEARANCES: Louis R. Moore, Esq., Billings, Montana, for Appellant; Peter J. Schaumberg, Esq., Howard W. Chalker, Esq., Geoffrey Heath, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE TERRY

Bailey D. Gothard has appealed from a June 12, 1996, Decision by the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS), denying Gothard's appeal of a July 20, 1992, MMS Order directing Gothard to pay additional royalties of $1,971.59. In August 1992, Gothard paid the additional royalties pending appeal and filed corrected reporting forms (MMS-2014's).

During the period covered by this appeal, December 1, 1982, through June 6, 1987, Gothard was the lessee of record for Federal lease 053-029536-0 (State #9-28 well), Toole County, Montana. The well was operated by Branch Oil and Gas Company (Branch) and the gas production was sold to Cascade Gas Company (Cascade), with whom Gothard had entered into an arms-length gas purchase agreement. Article VIII, section 1(a) of that agreement provided:

> With respect to any gas sold by Seller to Buyer which, at the time of such sale, is subject to the maximum lawful price limitations of the Natural Gas Policy Act of 1978, as amended, the price for such gas from each well each month shall be an amount equal to seventy percent (70%) of the maximum lawful price which Seller may legally receive for such gas as such maximum lawful price or prices are established and published by the Federal Energy Regulatory Commission, or any successor thereof, for each respective month in which said maximum lawful prices are applicable to any gas delivered from any well; * * *.

Title to the gas was transferred from Gothard to Cascade at the meter connection on the lease. Cascade, in turn, sold the gas to Montana Power Company (MPC). Gothard authorized Cascade to make royalty payments under the lease.

According to Gothard, the gas was low pressure and flowed naturally to a compressor located about 3/4 mile from the communitized area of the State #9-28 well, at which point Cascade's gathering system is connected to MPC's high pressure transmission system. (Statement of Reasons (SOR) at 2.) 1/

Pursuant to section 205 of the Federal Oil and Gas Royalty Management Act of 1982, 30 U.S.C. § 1735 (1994), the State of Montana reviewed Gothard's royalty payments and found that Gothard had underpaid royalties. The State determined that the underpayment was due to the fact that Gothard had excluded costs incurred in making the production marketable and had based the valuation of the gas for the purpose of computing royalty on Natural Gas Policy Act (NGPA) section 105, rather than utilizing the section 108 ceiling price. Section 108 of NGPA, 15 U.S.C. § 3318 (1982),

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1/ Compression of the gas occurred outside the communitized area. See affidavit of William F. Sheehan III, an officer of Northland Royalty Operating Company, present operator of the State #9-28 well.

repealed effective 1993, 2/ set ceiling prices for stripper well natural gas. Gothard challenged these determinations.

In its July 20, 1992, Order directing payment of additional royalties, MMS agreed with the State of Montana that underpayments were due to improper deduction of costs incurred in placing the gas into marketable condition and incorrect application of the pricing categories of NGPA. On appeal, these determinations were affirmed in the July 12, 1996, Decision of MMS' Associate Director for Policy and Management Improvement, which is the subject of the present appeal.

In the July 12, 1996, Decision, MMS determined that Cascade had gathered and compressed low pressure gas to meet market requirements. The MMS ruled that there was no market for the gas prior to gathering and compressing and that, under applicable precedent, costs of conditioning gas for market could not be deducted from gross proceeds received by the lessee in calculating the royalty amount. (Dec. at 2-3.) Thus, MMS determined that the value of the gas after it had been gathered and compressed by Cascade was the proper basis on which to assess royalties due to the Government.

However, MMS rejected use of the price actually received by Cascade from MPC as the basis for valuing the gas sold because it also concluded that this price was based on the NGPA section 105, and not the higher NGPA section 108 ceiling price which should have been obtained. The MMS noted that a lessee is obligated to obtain full value for its production for the benefit of itself and the royalty owner. The MMS pointed out that under Gothard's purchase contract with Cascade, Gothard was entitled to the "maximum lawful price," and based on this language, MMS argued that Gothard should have sought permission to sell the gas at the higher section 108 price to which it was entitled. Notwithstanding Gothard's failure to obtain such a classification, MMS found that it was not precluded to charge royalty based on the value the lessee could have obtained for his production. (Dec. at 3-6.)

Gothard asserts on appeal that it paid royalty based on the value established in its arms-length contract with Cascade. That is, it paid "the royalty percentage times 70% of the NGPA price received." Gothard contends that the gas was marketable without compression at the wellhead "as evidenced by the very fact that it was sold at the wellhead and that the 30% reduction represents the cost of transporting the low pressure gas through the Cascade Gathering System to its connection with the transmission line of MPC." (SOR at 3.) Gothard asserts that its contract with Cascade was "a sale contract, pure and simple" not "a contract to gather and compress gas." (SOR at 3.)

2/ Section 2(b) of the Natural Gas Wellhead Decontrol Act of 1989, Pub. L. No. 101-60, 103 Stat. 158. This statutory provision repealed the wellhead price control provisions of the NGPA, 15 U.S.C. §§ 3311-3333 (1994), effective Jan. 1, 1993.

In support of that part of its appeal related to gathering and compression expenses, Gothard relies heavily on Beartooth Oil & Gas Co. v. Lujan, CV 92-99-BLG-RWA (D. Mont. Sept. 22, 1993), vacating and remanding Beartooth Oil & Gas Co., 122 IBLA 267 (1992). In Beartooth, the lessee sold gas under an arms-length contract with Mesa Pipeline Company (Mesa). Mesa compressed the gas and sold it downstream to Mountain Fuel Resources (Mountain Fuel) under a separate agreement, also an arms-length transaction. The Board held that no deduction from royalty was allowed for expenses of compressing gas in order to make it marketable regardless of whether compression costs were paid directly by the lessee or by a third party. In the course of its rationale, the Board stated that "[c]ase law clearly establishes that Beartooth's sale of gas to Mesa does not compel a finding that the gas was in marketable condition at the time of sale." Id. at 271 (citations omitted).

In vacating the Board's decision, the court held in part that the Board erred in applying the marketable condition rule without considering the conditions under which the gas would be accepted by a purchaser under a sale contract typical for the field or area. 3/ Citing 30 C.F.R. § 206.151, 4/ the court found that, under applicable case law, the market of concern was "at the leasehold," not the remote market where the gas was resold the second time. 5/

With respect to the NGPA section 108 pricing issue, Gothard asserts that the regulations were inadequate to provide specific directions as to how to obtain an NGPA section 108 price category. Secondly, Gothard argues that MMS failed to provide notice of the time periods in which section 108 prices were applicable to its production. Thirdly, Gothard contends that it was not entitled to the NGPA section 108 price, and that MMS failed to determine, as required by NGPA, that the well was operating at its maximum efficient flow during the audit period. (SOR at 6-7.)

The MMS responds that MPC paid Cascade a higher price for the gas than Cascade paid Gothard. This demonstrates, MMS contends, that the value of the gas to MPC was greater than the value utilized by Gothard to calculate royalties. This difference in value resulted from placing the gas into marketable condition. (Answer at 3.)

3/ See Xeno, Inc., 134 IBLA 172 n.14 (1995).

4/ 30 C.F.R § 206.151 defines "marketable condition" as "lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area."

5/ The court's order in Beartooth is not included in the file. However, portions of the order are quoted in Gothard's SOR. In its Answer, MMS quotes the court as noting that `the case law does not support the contention that the market is 50 miles away from the leasehold * * *.' (Answer at 11.)

The MMS asserts that by accepting a lower price, Gothard effectively paid Cascade to gather and compress the gas. Citing precedent and authorities, MMS contends that costs incurred in making the gas marketable cannot be deducted from royalty value by paying a third party to make the gas marketable. (Answer at 5.)

The MMS argues that the Beartooth case is distinguishable in that the second sale here, between Cascade and MPC, occurred 3/4 mile from the communitized area (not 50 miles away as in Beartooth), and thus constituted "a market within a short distance of the well" and within the same field. Moreover, MMS notes, in the present case there is no evidence of an actual market at the well. Rather, the market was MPC. (Answer at 11.)

With respect to the NGPA section 108, MMS maintains it properly determined that the State #9-28 well was operating at its maximum efficient rate of flow during the audit period, and that, accordingly, section 108 prices were applicable. The MMS notes that the well did not exceed an average of 60 Mcf per production day for any 12-month segment during the audit period, as shown by the Schedule of Monthly Report of Operations, (Form 3160-6), prepared by the Montana State auditors. (Answer at 13; MMS Ex. 1.)

The MMS also states that by virtue of MMS' bill, Gothard had ample notice of the section 108 price. In addition, Gothard was free to challenge MMS' price determination on appeal if it chose to do so.

In Xeno, Inc., supra, some of the lessees formed a joint venture, the Battle Creek Gas Gathering System (BCGGS), to purchase the gas at the wellhead and resell the gas to MPC. Title was transferred from lessees to the gathering system operator at the wellhead, and the lessees paid royalties on the gross proceeds they received at the wellhead from the gathering system operator. Lessees participating in the joint venture were paid a higher price by BCGGS at the wellhead than other producers who sold the majority of like quality gas in the area. Id. at 175-76. In Xeno, Inc., the appellant contended that MMS incorrectly determined that gathering and compression costs were necessary to place the gas into marketable condition. The appellant argued that the gas, without gathering or compressing, was already in marketable condition at the wellhead. It supported this argument by citing offers made by companies other than BCGGS to purchase the gas at the wellhead without gathering or compression. In Xeno, Inc., MMS argued that it properly looked to the price paid by MPC, rather than the price received by Xeno from BCGGS to establish the value of the gas for royalty purposes, and that this price reflected the efforts of Xeno and BCGGS to place the gas into marketable condition. Id. at 176-77.

In Xeno, Inc., supra, at 180, we held that, under the "marketable condition rule," royalty is due on the gross proceeds accruing to the lessee including payments for the cost of measuring, gathering, and compressing gas where such services are necessary to place the gas in marketable condition. Mesa Operating Ltd. v. U.S. Department of the Interior, 931 F.2d 318, 323 (5th Cir. 1991). We noted further that it is well recognized in the Department that a Federal oil and gas lessee is under an obligation to assume the expenses of marketing any gas produced from the leasehold, and that no deductions are allowable for these operations. See The Texas Co., 64 I.D. 76, 79 (1957). We further stated in Xeno, Inc., supra, at 181:

> This rule of not allowing deduction of costs of gathering and compression of the gas for delivery at a point in the field when required pursuant to the sale contract has been upheld in subsequent cases. Kerr-McGee Corp., 22 IBLA 124 (1975); The California Co., 66 I.D. 54 (1959), aff'd, 187 F. Supp. 445 (D.D.C. 1960), aff'd, California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961). Further, the fact that compression takes place after the gas has entered the buyer's pipeline does not alter this result where such compression is required as a condition of sale. Big Piney Oil & Gas Co., A-29895 (July 27, 1964).
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> In upholding the Department's position, the court in California Co. v. Udall, supra, noted that: "In the record before us there is no evidence of a market for the gas in the condition it comes from the wells. The only market, as far as this record shows, was for this gas at certain pressure and certain minimum water and hydrocarbon content." 296 F.2d at 388, quoted in Big Piney Oil & Gas Co., supra.

[1] The marketable condition rule is applicable in cases such as the case now before us, where the gas was sold at the wellhead to a gathering system operator who compressed the gas in order to introduce it into a market pipeline. Deductions from the value of the gas for these expenses are not allowed whether incurred by the lessee or a third party, before or after the initial sale of the gas, when the evidence discloses that this is necessary to market the gas. Xeno, Inc., supra, at 181; R.E. Yarbrough & Co., 122 IBLA 217, 221 (1992).

Although the Board in Xeno, Inc. affirmed the applicability of the marketability rule in proper circumstances, it vacated and remanded the MMS decision in that case because MMS had valued the gas solely based on what the second buyer, MPC, paid BCGGS, and had not analyzed "what constitutes marketable condition in the context of the gas produced in the field at issue." Id. at 182. In Xeno, Inc., the Board found that there was evidence that the gas was under sufficient pressure to be marketable at the time it was first sold by the lessees to BCGGS, and that competing offers to purchase the gas at the wellhead were made. For these reasons the Board distinguished Xeno, Inc. from cases such as The Texas Co., Yarbrough, and Beartooth, supra, in which the marketable condition rule was applied. Xeno Inc., supra, at 182-83. Further, the Board discussed the distinction between gathering and transportation costs, noting that the latter are allowable as an adjustment to the lessee where transportation of the gas from the wellhead to the point of delivery is not required to put the gas in a marketable condition. Id. at 183-84.

In the case now before us, there is no evidence that the gas was under sufficient pressure or that there were competitive price offers for the low pressure gas at the wellhead. In short, there is no "context" to establish marketability of the gas prior to gathering and compression. Rather, the evidence shows that these operations were necessary to render the gas suitable for MPC's pipelines and thus marketable. Moreover, since the gas was not marketable prior to these operations, there is no issue as to a transportation allowance.

Gothard's contention that its contract with Cascade was a sales contract, rather than a contract to gather and compress the gas, is of no avail. In California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961), the court, discussing the lessee's duty to market, and not merely sell, the gas, held that the statutory term "production" could reasonably be construed to mean gas conditioned for market. The court found that there was

> a clear difference between "marketing" and merely selling. For the former there must be a market, an established demand for an identified product. We suppose almost anything can be sold, if the price is no consideration. In the record before us there is no evidence of a market for the gas in the condition it comes from the wells. The only market, as far as this record shows, was for this gas at certain pressure and certain minimum water and hydrocarbon content.

296 F.2d at 388 (footnote omitted).

Accordingly, MMS properly determined that gathering and compression costs could not be deducted where these operations are necessary to market the gas.

We now consider whether MMS correctly held the NGPA section 108 price applicable to Gothard's gas production for the period in question. The relevant regulation regarding royalty valuation at the time of the gas sales in question provided:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product * * * due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof * * *. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or

other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

30 C.F.R. § 206.103 (1983) (formerly codified at 30 C.F.R. § 221.110).

[2] As we noted in Trigg Drilling Co., 138 IBLA 375, 380 (1997), the regulated ceiling price under the NGPA is one of the relevant factors to be considered in valuing gas under the valuation regulation at 30 C.F.R. § 206.103 (1983). See FMP Operating Co., 121 IBLA 328, 331 (1991); Phillips Petroleum Co., 117 IBLA 230, 233 (1990). It is incumbent upon the lessee to diligently apply for certification and to obtain the highest ceiling price for which the gas is eligible, because the lessee has an obligation to market the gas at the best price obtainable, consistent with reasonable business judgment. Harding v. Cameron, 220 F. Supp. 466 (W.D. Okla. 1963); Dugan Production Corp., 111 IBLA 181, 185 (1989).

This highest ceiling price is one of the relevant factors for royalty valuation purposes. Trigg Drilling Co., supra, at 380 and cases cited therein. The ceiling price assumes an even greater importance because it was incorporated into Gothard's gas purchase agreement as a material basis for establishing the sales price for the gas produced and sold. See FMP Operating Co., supra, at 331. Where, as in the case now before us, the lessee received less than the maximum ceiling price allowed under the NGPA, royalty valuation may properly apply the maximum Federal ceiling price. Trigg Drilling Co., supra.

Gothard has not effectively challenged the eligibility of its production for the section 108 price nor does the record disclose any justification for the acceptance of a lower price. As the case law cited holds, it is the responsibility of the lessee, not MMS, to exercise reasonable business judgment and to diligently attempt to obtain the highest ceiling price. Gothard's argument relating to a lack of notice is an attempt to shift this responsibility. Gothard cites 45 Fed. Reg. 12137 (Feb. 22, 1980). (SOR at 6.) That Federal Register Notice provided detailed instructions to lease operators on how to file for natural gas category determinations with the appropriate oil and gas supervisors as provided under NGPA and the Federal Energy Regulatory Commission. The information published in the Federal Register is precisely that which Gothard complains was unavailable to it. Gothard is deemed to have constructive knowledge of pertinent publications in the Federal Register. 44 U.S.C. § 1507 (1994); Coastal Oil & Gas Corp., 140 IBLA 200, 204 (1997).

The State determination, as affirmed by the MMS decisions in this case, was that, based on production figures for the State #9-28 well, approval for an NGPA section 108 classification should have been sought under 18 C.F.R. § 271.807(b)(2) and (c) (1982), and interim collections begun in accordance with 18 C.F.R. § 273.202(a)(1) (1982), beginning in December 1982. See July 20, 1992, MMS Dec. at 4. The regulation at 18 C.F.R. § 271.807(c) provides that if prior production data for a 12-month period are not available

> the jurisdictional agency shall designate 12-month period during which the applicant may secure the data establishing that the well produced natural gas at an average rate not in excess of 60 Mcf per production day. The applicant may submit such data not later than 90 days after the close of such 12-month period, and if such data show that the well's production did not exceed 60 Mcf per production day, the jurisdictional agency shall make an affirmative determination.

As MMS points out in its Answer at 13, the State #9-28 well did not exceed an average of 60 Mcf per production day for any 12-month period as shown by Monthly Report of Operations, Form 3160-6, nor, in fact, for any single month at all. (MMS Answer, Ex. 1.) The record indicates that MMS properly determined that the NGPA section 108 price was applicable to Gothard's production.

To the extent not addressed herein, Gothard's other arguments have been considered and rejected.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the Decision appealed from is affirmed.

James P. Terry
Administrative Judge

I concur:

James L. Burski
Administrative Judge